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Regans' Notes

Macroeconomic Consensus

We think many investors are expecting the following:

1. A recession
2. The Federal Reserve (Fed) is close to or already done raising rates
3. Disinflation, albeit slowly

This raises the obvious question, "What unexpected event(s) could happen that would move markets?" When many expect the same event or outcome, "a Black Swan" unexpected event could produce significant market moves. A few unexpected events might include:

- What if inflation doesn't come down after all these rate increases?
- What if inflation plateaus around 4.5% or so?
- Will the Fed un-pause their rate hiking campaign if inflation does not come down as they want?

While we are not expecting any of the above to occur, we find any one of these events are possible. We point out these possibilities because of the current top-heavy concentration in the U.S. equity market.

Multiple wars and conflicts around the world, alarming extreme weather events, a global pandemic, trade tensions between major economies, rising levels of public and private debt, slowing global trade and economic growth –all possible impacts on our economy and financial markets in the past, present, and future.

We never expect the economy and financial markets to be worry free nor do we ever expect them to be lacking opportunities.

Concentration Issues

FS Investments published the following data which we found worth sharing:

- Concentration in U.S. equity markets has risen sharply since 2015.
- In the first five months of 2023, 88% of the gains in the S&P 500 can be attributed to seven of the largest stocks in the index. A market-cap weighted index of those seven stocks had a cumulative return of over 40% while the S&P 500 equal-weighted index barely broke even.

Similarities exist between the dot-com bubble of the late 1990's (mainly, the dominance of technology firms) but there are also important differences.

The top 10 stocks share of total S&P 500 earnings versus their weight of the total market cap are as follows:

In the late 1990's:

15% of the index's total earnings

vs.

20% of the index's market cap

Currently

25% of the index's total earnings

vs.

30% of the index's market cap

Today's mega caps contribute a larger share of a much larger earnings pie. Not a bubble, in our opinion, but not a bargain.

A Market of Stocks, Not a Stock Market

The top 10 stocks have very impressive free cash flow generation, which supports their dominance and sets this environment apart from the dot-com era. On the other hand, the valuations for the top 10 appear stretched relative to the rest of the market.

The current historic levels of equity concentration make for a challenging investing environment.

In hindsight, investing in the S&P 500 index in 2015, when concentration was near an all-time low had excellent results. Not only did an investor get exposure to a well-diversified (unconcentrated) index, but they were able to passively participate in the group that would become today's dominant stocks.

Today's investing environment looks completely different to us. Investing in the S&P 500 index currently implies a concentrated investment in a small group of stocks whose relative valuations are elevated from a historical standpoint. The top stocks have similar return drivers with many in the technology and communications services sector which are highly correlated to each other and have a high correlation to bonds and interest rates.

The macro environment that helped these stocks flourish--globalization and ultra-low interest rates appears to us to be at risk more than as it has been in decades. We think we are in a different investing environment than the one that predominated for the past 15 years and it will require investors to adjust their way of thinking. So, what are the changes?

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Adapting Adjusting

Darwin pointed out long ago survival does not go to the smartest, fastest, nor strongest, but to those who can adapt. We think a portfolio that can adapt over the long term by avoiding extremes will serve investors best. Here are a few ways we suggest to adapt / adjust.

Fight complacency

The outperformance of the top 10 stocks in the S&P 500 index since 2015 is contrary to most past periods in history. Source: FS Investments We believe risks from regulatory action, geopolitics and disruption are heightened for the largest stocks and think these risks will be passed onto the market as a whole due to the elevated concentration.

Diversify globally

The U.S. share of global equity stock markets has risen from 30% to more than 40% today and most other regional markets have not experienced nearly the same concentration that the U.S. market has. Thus, we believe it may be beneficial for markets outside the U.S. to play a more important role than they did over the past decade.

Increase "active" investment management

Since 2015, persistently rising concentration has made it challenging for active strategies to outperform passive funds which programmatically assign higher and higher weights to the leading stocks. We believe any stall or reversal in that trend would likely benefit active strategies.

AI

Is the recent equity market performance real, or artificially generated? How much and how quickly AI will change the world around us remains to be seen, but its impact on markets has been swift and powerful.

In the near term we think investors should temper any euphoric expectations they may have about AI's current market leadership, while not dismissing the potentially transformative potential.

Not everyone can be an AI winner. The rapid development of generative AI, which creates algorithms to produce new content (audio, software code, images, text and more) will ultimately result in a major technology platform shift.

Advances will not come cheap, as infrastructure (foundation models) for AI applications has high upfront costs and requires intensive human, capital and other resources that may be scarce for some would-be AI leaders. That means the largest companies with huge cash balances and access to proprietary data platforms should have a meaningful competitive advantage in AI development.

In contrast some legacy technology businesses may struggle as AI adoption continues over the next few years. Those with strong user access and distribution capabilities will likely fare better.

Our Mission

Achieve superior results for our clients by providing institutional level investment management and consulting services.

What We Do

We help clients realize their vision of the future with personalized investment planning.

Our client specific strategies use independent, full-time professionals to research and manage portfolios for long-term growth of assets.

Our services include:

- **Over 50 years of experience** in both up and down markets.
- Independent, objective advice from professionals with the expertise you need to help you achieve your goals.
- Investment strategies appropriate for **long-term, serious, core money.**
- Asset allocation strategies customized to fit clients' unique needs, risk tolerance, and time horizons.
- A disciplined investment process.
- Portfolios that attempt to provide **more consistent returns with reduced volatility** over time.
- **Seek out, screen, and hire** high- quality money managers to run portfolios of individual securities.
- **Ongoing review** of the chosen managers' process, personnel, and investment decisions and report their performance quarterly.
- Replace managers when necessary.

Clients have trusted us for decades to provide their investment services.

We continue to grow and appreciate your introductions to friends and family. Our target markets are clients just like you – individuals, foundations, endowments, retirement plans, and corporations.

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